VZCZCXRO1264
RR RUEHDA
DE RUEHAK #1015/01 1201421
ZNR UUUUU ZZH
R 301421Z APR 07
FM AMEMBASSY ANKARA
TO RUEHC/SECSTATE WASHDC 1902
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUEHIT/AMCONSUL ISTANBUL 2600
RUEHDA/AMCONSUL ADANA 1900
RUEHBS/USEU BRUSSELS

UNCLAS SECTION 01 OF 03 ANKARA 001015

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E.O. 12958: N/A
TAGS: EFIN BEXP ETRD TU
SUBJECT: TURKEY: ECONOMISTS STRESS ECONOMIC PROGRESS, BUT NEED FOR MORE REFORMS

Ref: Ankara 801

This cable has been coordinated with Congen Istanbul.

¶1. (SBU) Summary: As domestic political risk comes to the fore in the wake of the weekend's dramatic developments, Turkish economists underline the economy's remarkable transformation since the 2001 crisis. Strong growth, fiscal consolidation and surging Foreign Direct Investment underpin a significant reduction in economic vulnerabilities: debt ratios are stronger, banks are well-capitalized, and the current account remains easily financed. This contrasts previous periods of political instability that coincided with economic weakness and vulnerability in 2001, 1999-2000, 1997, and 1980. While the country's financial cushion seems sufficient to weather a passing political storm without a market or economic crash, economists' biggest fear is an extended period of policy doldrums and disarray that would delay a second generation of reforms needed to sustain the high growth that will allow Turkey's living standards to converge with EU averages. They will be watching closely for signs of a political consensus that will leave the economic reform agenda intact. End Summary.

The Other Shoe Never Dropped

¶2. (SBU) In a round of meetings before the weekend's events, Ankara-based economists in Government agencies, the Central Bank, the bank regulatory agency and an independent think tank were uniformly positive in their assessment of the Turkish economy, stressing in particular how far it has progressed since the 2001 crisis. Turkey has experienced five straight years of growth averaging over 7%, reduced its public sector debt ratios, attracted newly-high levels of FDI, and brought inflation down to around 10%. Although the think tank economists, including former Central Bank Governor Serdengecti, are more willing to point out the economy's weaknesses, they also acknowledge the dramatic improvements.

¶3. (SBU) Moreover, the full-year 2006 data -- and the absence of public or private financial problems -- have put to rest fears that the May-June 2006 market correction would damage Turkey's economic recovery. In the immediate aftermath of the correction, many analysts wondered whether corporations that had borrowed in foreign exchange would suffer financial difficulties that might only become

visible with a lag. None of the economists we spoke with had seen any evidence of financial stress from last year's correction. Bank Regulatory and Supervisory Agency (BRSA) officials said they did not seen signs of rising non-performing loans in the banking sector.

Transformed Banking Sector

¶4. (SBU) Among the areas in which Turkey's vulnerability is much-reduced is the banking sector. The 2001 crisis was a banking crisis, with regulators working to clean up the mess for several years thereafter. Few analysts now worry about the sector's vulnerability. If the May-June volatility was a test, the Turkish banking sector passed it with flying colors. Despite initial worries that the sector would suffer losses arising from its asset-liability maturity mismatch (long-dated assets and short-dated deposits) the impact was minor. BRSA officials told us the sector's Capital Adequacy Ratio (CAR) was 21% as of year-end 2006, the highest in the OECD. After the May-June correction, no bank had fell below the 8% statutory CAR, although some had fell below the 12% threshold below which BRSA will not approve new branch openings. These banks have since strengthened their capital position to exceed the 12% level.

FDI Takes Off

¶5. (SBU) Perhaps the most striking change in Turkey has been the take-off in Foreign Direct Investment (FDI). After averaging less than $2 billion a year from 1990 to 2004, FDI hit $9.6 billion in 2005 and $20 billion in 2006. Early fears that FDI would drop sharply in 2007 have yet to materialize, with $13 billion so far

this year. Although critics note the absence of significant greenfield foreign investment and wonder whether FDI will fall off once all the available banks have been bought and the privatization process winds down, foreign companies continue to buy into Turkey in a broad range of sectors, suggesting the FDI wave has far from run its course. Domestic investment also continues to be strong, in part because Turkish groups that sold bank assets to foreign are reinvesting in other sectors.

Downplaying Current Account Deficit Fears

¶6. (SBU) Among the vulnerabilities that remain, of course, is Turkey's large current account deficit (CAD) that grew to 7.9% of GDP in 2006. All of the Ankara-based economists we spoke with downplayed the seriousness of the CAD issue. First, they pointed to the relative ease with which Turkey is financing the deficit, with FDI accounting for 60% of the deficit in 2006 and increased long-term borrowing, reducing the dependence on short-term funds. Moreover, the economists point to the fact that it is the private sector that is borrowing and investing, buying the imported goods that are driving the current account deficit. They also emphasize the composition of imports, which are heavily weighted towards intermediate goods with a very small share of consumption goods. Central Bank economists said Turkish industry is shifting from labor- intensive businesses into higher-value, capital-intensive businesses, a transformation we are seeing in many sectors, including textiles.

¶7. (SBU) In contrast, some private sector financial analysts express concern over the macroeconomic conundrum posed by the need to maintain nominal interest rates at 17.5% in order to attract the capital flows that fund the current account deficit. Rates this high make credit very unattractive for domestic borrowers and stifle economic growth. A reduction in interest rates would result in decreased capital inflows and could prompt a sharp decrease in the value of the lira. These economists dismiss arguments that productivity gains would fuel growth arguing that a massive unregistered labor force made labor productivity statistics

virtually useless. Arguments that the composition of imports (heavily weighted toward capital goods) would eventually lead to export-led growth were also dismissed as wishful given historical trend data.

¶8. (SBU) Most economists are projecting a slight easing in the CAD as a share of GDP in 2007, to around 7%. The data for the first two months of 2007 are encouraging, with exports growing 25% and imports 20% in value terms, while export volumes grew even more rapidly. The Central Bank economists see a link between the slowdown in domestic demand growth and export growth, making the case that Turkish manufacturers are able to shift sales from domestic buyers to international customers. The weakness of the dollar against euro and the resurgence of growth in Europe, Turkey's principal trading partner are both helpful. With many of Turkey's inputs dollar-denominated and 58% of exports to the EU, dollar weakness against euro helps Turkey's terms of trade. A national accounts restatement expected at some point this year would be a purely mathematical improvement, but could give a significant boost to GDP/GNP and result in major improvements in Turkey's macroeconomic ratios.

Fewer Debt or Market Worries

¶9. (SBU) Turkey continues to reduce its vulnerability to public sector debt rollover risk. As of December 31, 2006 public sector net indebtedness was 44% of GDP, of which only 8% is foreign exchange-denominated. Although this is still above some comparator countries it represents a striking improvement from 90% in 2001. The overall deficit of the public sector shrank from 16% in 2001 to under 3% in 2006. Turkish Treasury and Central Bank officials also note the improved structure of the debt, as Treasury has succeeded in extending the yield curve by issuing first 3-year and then 5-year fixed rate bonds, as well as inflation-linked floating rate notes. These have brought the average maturity of domestic public debt to 24 months, up from 15 months in 2001.

¶10. (SBU) As a result, fears of Government problems rolling over its short-term debt have receded. If the markets were to experience another bout of turbulence, however, both the Central Bank and Treasury have built up sizable reserves -- $68 billion and $15 billion respectively -- reassuring investors that they stand ready in case of market problems. In fact, the reserves are so large, and the vulnerabilities sufficiently reduced, that Institute for International Finance Economist Jeff Andersen told us Treasury should use the reserves to reduce debt, thereby shrinking the supply of government paper and reducing interest rates.

¶11. (SBU) With regard to the foreign exchange market, Central Bank officials and other economists pointed out that residents' increased stock of foreign exchange has created a fundamentally more positive situation than existed before last spring's sell-off in the lira. If the lira were to fall sharply, these local investors are widely expected to come back into lira to take advantage of the buying opportunity for their home currency. Once Turkey gets past its election-year political problems, these residents are expected to come back into lira assets.

Stubborn Inflation

¶12. (SBU) Although inflation came down dramatically from 2001 through 2005, since then it seems to be stuck around 10% with the Central Bank struggling to resume the disinflation trend. Higher energy prices and the exchange rate correction hurt in 2006 as have drought-induced higher food prices. The Bank is hopeful that the second half of 2007 will be provide a breakthrough but remains concerned about the stickiness of services prices, with people tending to set prices based on backward-looking inflation indicators rather than based on future expectations which are nearing 7% for yearend 2007. Even if services prices remain sticky, a Central Bank

economist pointed out services account for 25% of the CPI basket, such that by bringing down other prices, the Central Bank can bring down the headline number and gradually influence services price-setting behavior.

Avoiding Complacency, Continuing Reforms

¶13. (SBU) With all these improvements, the Turkish economy is in a fundamentally better position than it was during early periods of political tension such as 1980, 1997, 1999-2000 or the 2001 crisis. Despite the stronger fundamentals, observers such as former Central Bank Governor Serdengecti caution against complacency. He, along with most observers, attributes the continued very high real interest rates to political risk. In this regard, the biggest risk is a return to the policy drift of the "lost decades" of the 1980s and 1990s, when Turkey was not able to achieve a stable political consensus. Markets have thrived under the pragmatic policies of a single party government since 2002. The economic reform process is far from over, and some of the most politically challenging reforms have yet to be implemented in areas such as the labor market, education, and the judiciary. If these reforms -- which have been driven by the IMF program and EU accession process -- are put off, Serdengecti and his colleagues expect much lower growth rates than the 7% per year needed to create jobs needed to and converge income levels to a level approaching 50% of that of the EU.

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